

GOOD GOVERNANCE PRACTICES A KEY TO SUCCESS

Achieving Good Governance in OCIO Mandates



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Good governance practices, such as clear articulation of roles and responsibilities, allow pension funds to have better decision-making and risk management processes. They also help provide clearer accountability for results, which allows for corrective action should a pension fund not achieve its objectives. In fact, pension funds with strong governance policies tend to have better financial performance and improved cost efficiency.

This is borne out in research done by Keith Ambachtsheer, director emeritus of the University of Toronto's Rotman International Centre for Pension Management. His research shows that pension funds with a robust governance structure, on average, outperform poorly governed funds by 1% to 2% annually. In addition, better-governed institutions earn more trust from their stakeholders.¹

WHAT IS GOOD GOVERNANCE?

Pension funds and their boards are increasingly focusing on good governance. But what characterizes good governance? Good governance is not the same as a lot of governance. Adding extra governance measures provides diminishing marginal returns as the resulting structure becomes too complicated and costly to be effective. More governance is not necessarily good; we believe smarter and better-designed governance is.

Good governance is basically about two things: Clear separation of duties, and proper checks and balances. Pension funds, in particular, have many layers of delegated decision-making (from boards of directors to staff; from staff to outside vendors), and multiple entities/agents as noted below. Unless clear roles and responsibilities are assigned to each level of decision-making, the fiduciary responsibility to the fund can be compromised.

This becomes even more important when pension fund trustees are considering the use of an outsourced CIO (OCIO) mandate. While using an OCIO provider is a step that, in itself, can help improve a pension fund's governance, it does not mean that all governance issues are solved.

GOOD GOVERNANCE PRACTICES FOR OCIO MANDATES

An OCIO mandate usually involves multiple parties. Using a pension fund as an example, the parties involved typically would include the pension board, the OCIO provider, the external asset managers, the actuary and the custodian. In some situations, the arrangement could include others as well. In such a complex setting, separation of duties is essential. The governing agreements between the pension fund and the OCIO provider should clearly specify who is responsible and accountable for which activities.² Leaving the specification of responsibilities vague can easily lead to confusion and suboptimal outcomes.

¹ See "How Much is Good Governance Worth?" Chapter 19 in Keith Ambachtsheer (2007): *Pension Revolution*, Wiley. Ambachtsheer's findings have been confirmed in a recent study among Swiss pension funds: Ammann, Manuel, and Christian Ehmann (2014): "Is Governance Related to Investment Performance and Asset Allocation? Empirical Evidence from Swiss Pension Funds," University of St. Gallen Working Paper.

² The governing agreements usually consist of the investment management agreement (IMA) and investment policy statement (IPS).



DEFINING ROLES AND RESPONSIBILITIES

To ensure effective separation of duties, a board must specify responsibility for a number of investment activities, such as:

- **Strategic Asset Allocation (SAA):** This could be done by the OCIO provider, the pension board or jointly. While there is no right or wrong model, it is very important to specify responsibility for SAA at the start of the mandate.
- **Dynamic Asset Allocation, or Changing Your SAA:** Again, the OCIO provider can take responsibility for dynamic asset allocation, the pension board can handle it or the responsibility can be shared. No matter which model you choose, responsibility and accountability should be clearly defined from the outset.
- **Tactical Asset Allocation (TAA):** Regardless of whether the OCIO provider, the pension board, or one of the external asset managers handles TAA, be very clear about whose responsibility this is, how much risk that party is allowed to take, and what other guidelines should be part of this process.
- **Manager selection and allocation:** Hiring, monitoring, firing and deciding how much money to invest with external asset managers (and when) is one of the OCIO provider’s main tasks. However, the pension board should determine whether it wants the right to veto a manager selected by the OCIO provider and, if so, under what conditions it would exercise this right.
- **Manager monitoring:** How involved does the pension board want to be in this process? The boards of large pension funds with their own internal staff often will want to talk to their asset managers to learn first-hand about any issues, whereas the boards of pension funds with limited or no internal staff typically choose to fully delegate this function.
- **Proxy voting and engagement:** Be clear from the outset who is responsible for performing these activities.
- **Compliance management:** This is usually done at the asset manager level, but the custodian can play an important role as an independent check on the managers, as well as on a total pension fund level.
- **Reporting:** The numbers on which reporting is based should be comprehensive. A pension board may choose, or in some cases (such as in the Netherlands) may be required, to ensure the reporting is verified by an independent source. Again, the custodian can play a useful role here.

Table 1 below presents an example of a governance matrix that a pension board might want to complete during this important planning stage. The matrix details the key activities, the party responsible for each activity, who monitors this entity, and how the performance is evaluated or validated.

TABLE 1: SEPARATION OF DUTIES

| Processes | Advise | Decide | Implement | Monitor | Validate |
|------------------------------------|--------|--------------------|---|--------------------------------|----------|
| Investment Policy Statement | OCIO | Board ³ | OCIO | OCIO or Internal Pension Staff | Board |
| Strategic Asset Allocation | OCIO | Board | OCIO | OCIO | Board |
| Tactical Asset Allocation | Board | OCIO | OCIO and/or External Managers | OCIO and/or External Managers | Board |
| Manager Selection | Board | OCIO | OCIO | OCIO | Board |
| Manager Monitoring | Board | OCIO | OCIO | OCIO | Board |
| Proxy Voting and Engagement | Board | Board/Manager | OCIO or Manager or Internal Pension Staff | OCIO or Internal Pension Staff | Board |
| Compliance Management | OCIO | Board | Manager | OCIO or Custodian | Board |
| Reporting | OCIO | Board | OCIO | OCIO | Board |

³ Or pension committee.

INSTITUTING CHECKS AND BALANCES

Once a pension board has clearly defined roles and responsibilities, it is crucial that the board ensures the proper checks and balances are in place. Here are a few relevant issues to discuss with a current or potential OCIO provider:

- **The role of the search consultant:** If you use a search consultant to find an OCIO provider, make sure the consultant is totally objective. Loss of objectivity can occur when a consultant offers services that directly compete with OCIO providers or receives consideration from an OCIO provider, such as referrals for other OCIO searches or even a fee.
- **“Veto rights” on selection of external asset managers:** An OCIO provider will select external asset managers to manage the pension plan’s capital. Because the fund’s board or pension committee retains ultimate responsibility for the management of its assets, a recommended practice is to retain a right to veto the managers selected. This practice is fairly common in parts of Europe, but it is still a relatively new concept throughout much of North America. While a pension fund’s board or committee might choose to exercise its veto rights for a number of reasons, it may be better served to only do so in exceptional circumstances. Overuse of a veto could unnecessarily frustrate the investment process.
- **Establish a policy for internal products:** The main task of an OCIO provider is to select, monitor and replace external asset managers. Often, however, the OCIO provider is an active asset manager itself. To avoid potential conflicts of interest, ask the OCIO provider about its policies related to its proprietary products. For example, the OCIO provider may include recommendations for its own strategies only if they’re recognized in the market as world-class capabilities. Alternatively, the OCIO provider may review and approve proprietary strategies, such as index, that are designed to closely track benchmarks, are low cost and have a transparent, clear process.
- **Independent risk management and oversight:** Broadly speaking, a pension fund is exposed to two types of risk:
 1. Asset-liability risk – the risk that the strategic asset allocation portfolio does not meet funding policy and investment policy targets.
 2. Implementation risk – the risk that inefficient implementation of the investment policy leads to suboptimal outcomes.

Simply put, asset-liability risk is about getting the betas for both liability hedging and return-seeking allocations right. Implementation risk is a bit more involved, as it can include the risk that the OCIO provider and the external managers underperform their benchmarks (the alpha part of the portfolio), as well as the risk that processes, decisions and evaluations of results do not adhere to the governing agreements (operational risk).

Establishing proper checks and balances requires careful thinking about possible conflicts of interest and risks, and setting up a structure that can help mitigate these as much as possible.

OVERCOMING PRACTICAL HURDLES

Good governance is an important element of successful pension fund management, but committing to the idea isn’t enough. To successfully implement good governance practices, a pension board or investment committee needs to clear a number of practical hurdles.

- **Evolving governance standards.** Governance structures have evolved over time. While many board or pension committee members may feel comfortable with the status quo and disinclined to make significant changes, failing to update standards can prove detrimental to the pension fund. The regulatory, risk-management and investment environments have all changed – some significantly – in recent years. To help ensure the pension fund’s ongoing success, the board or committee must ensure governance structures are keeping pace with today’s standards.
- **Rising cost of good governance.** Of course, there are added costs that come with better governance. For example, the recommendations set forth in this paper cost money up front, while the benefits may not become visible after quite some time.

- **Weighing the effect of relationships.** Strong personal relationships between consultants and pension fund sponsors are often highly valued. When a change is needed that could hurt this relationship, board and committee members' desire to maintain the relationship could hamper their decision-making process.

DEVELOPING STRONG PRACTICES NOW PROVIDES LONG-TERM BENEFITS

Pension funds, with their multiple layers of decision-making (from boards to staff to outside vendors), are focusing on good governance practices. Unless clear roles and responsibilities are assigned to each level of decision-making, the fiduciary responsibility to the fund can be compromised. Pension fund managers who focus on incorporating good governance standards into their fund management practice, and who are aware of the challenges in doing so, increase their chance of success.

When working with an OCIO mandate, the governing agreements should reflect a pension fund's investment profile and help reinforce the governance structure the board desires. Likewise, a board needs to commit to properly overseeing the asset allocation and implementation of the portfolio, and clearly spell out in the governance matrix (Table 1) who is responsible – whether this is handled internally through a pension committee or through a third party, such as an external vendor who understands the pension business and has the analytical capabilities.

LEARN MORE

If you would like to learn more about the relationship between good governance and OCIO mandates, please contact Margret Duvall at 312-444-7336.

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